No. 83-26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DONALD I. LAVENTHALL,

Petitioner,

—vs.—

GENERAL DYNAMICS CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

ROBERT B. BLOCK
295 Madison Avenue
New York, New York 10017
(212) 532-4800

Attorney for Petitioner

Of Counsel:

BRUCE G. STUMPF
Pomerantz Levy Haudek Block & Grossman
295 Madison Avenue
New York, New York 10017
(212) 532-4800

JOHN L. DAVIDSON, JR.
Greenfield & Davidson
721 Olive Street
St. Louis, Missouri 63101
(314) 241-5735

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QUESTION PRESENTED FOR REVIEW

Whether the court below, in expatiating upon this Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), and creating a wide loophole in the federal securities laws, incorrectly leaves investors on the nation's second largest securities market, the Chicago Board of Options Exchange, without the same protection against insider trading as possessed by investors in other securities markets.

PAGE

Question Presented For Review i

Table of Contents iii

Table of Authorities iv

Opinions Below 1

Jurisdiction 1

Statutes Involved 2

Statement Of The Case 3

The Claim 3

The Facts 3

Proceedings Below 5

Reasons For Granting The Writ 6

A. The Court Below Has Created A Loophole In The Federal Securities Laws Which Will Invite Fraud and Injure Investors In The Public Options Markets 8

B. The Court Of Appeals' Reliance Upon Notions Of "Privity" And "Special Relationships" Is Misplaced, Given The Nature Of Modern Securities Markets 13

Conclusion 16

Appendix

Opinion Of The Court Of Appeals 1a

Order Of The District Court 15a

Opinion Of The District Court 16a

TABLE OF AUTHORITIES

Cases PAGE

Backman v. Polaroid Corp., 540 F. Supp. 667 (D. Mass. 1982) 12

Baretge v. Barnett, 553 F.2d 290 (2d Cir. 1977) 13

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 9, 13

In re Cady, Roberts & Co., 40 SEC 907 (1961) 7

Chiarella v. United States, 445 U.S. 222 (1980) . . . . *passim*

Conley v. Gibson, 355 U.S. 41 (1957) 3

Cruz v. Beto, 405 U.S. 319 (1972) 3

Elkind v. Liggett & Meyers, Inc., 635 F.2d 156 (2d Cir. 1980) 7

Green v. Hamilton International Corp., 437 F. Supp. 723 (S.D.N.Y. 1977) 7

Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969) 13

Herman & MacLean v. Huddleston, ____ U.S. ____, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983) 7, 8, 11

J.I. Case Co. v. Borak, 377 U.S. 426 (1964) 12

Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), *reh. denied*, 404 U.S. 1064 (1972) 13

O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981) 12

Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974) . . 14

Securities and Exchange Commission v. Banca Della Svizzera Italiana 92 F.R.D. 111 (S.D.N.Y. 1981) 9

Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 903 (1969) 13, 15

PAGE

Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) 7, 13, 14, 15

Texas Continental Life Insurance Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962) 13

Statutes and Rules

Securities Act of 1933, 15 U.S.C. § 77a, et seq. 8

Securities Exchange Act of 1934

§ 2, 15 U.S.C. § 78b 8

§ 3(a)(10), 15 U.S.C. § 78c(a)(10) 6, 9, 11

§ 10(b), 15 U.S.C. § 78j(b) .... *passim*

§ 16(b), 15 U.S.C. § 78p(b) 11

§ 27, 15 U.S.C. § 78aa 3

Securities and Exchange Commission Rules

Rule 10b-5, 17 C.F.R. § 240.10b-5 .... *passim*

Other Authorities

E. Brodsky, "Insider Trading," *New York Law Journal* (June 15, 1983) 11

D.C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement," 70 Cal. L. Rev. 1 (1982) 11

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Sec. Reg. L. Rep. (BNA) (May 27, 1983) 9

Senate Report No. 792, 73d Cong., 2d Sess. (April 20, 1934) 11

W. Williams, "Insider Trading and Options," *New York Times* (April 13, 1983) 10

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 704 F.2d 407 (1983). (1a)

The opinion of the United States District Court relating to the issue for which review is sought by this Petition is not officially reported. (16a) A separate opinion of the District Court on an issue for which review is *not* sought is reported at 91 F.R.D. 208 (1981).

JURISDICTION

The decision of the Eighth Circuit was dated and filed on April 6, 1983. (1a) Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Section 10 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated by the Securities and Exchange Commission under § 10(b) of the Exchange Act, provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> * * *
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> * * *
>
> (c) To engage in any Act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

The Claim

Petitioner commenced this class action on March 4, 1980 to recover damages sustained as a result of respondent's alleged trading on inside information in violation of § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.[1] Federal jurisdiction was based upon § 27 of the Exchange Act, 15 U.S.C. § 78aa.

The Facts[2]

Respondent, General Dynamics Corporation, is a large, publicly-held corporation engaged, *inter alia*, in the design, manufacture and sale of military and commercial aircraft, submarines, weapons systems, and telecommunications systems. In 1979, it had outstanding approximately 27 million shares of common stock which traded on the New York, Midwest, Pacific and Montreal Stock Exchanges, plus an issue of preferred stock (convertible into common) which traded on the New York Stock Exchange. In addition options—which gave holders the right over a certain period of time to buy or sell General Dynamics' common stock at specified prices—were publicly traded on the Chicago Board of Options Exchange ("CBOE").

During the years 1971 through 1978, General Dynamics paid no cash dividends to holders of its common stock. After

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1 The class alleged consisted of all persons who sold securities of defendant-respondent, General Dynamics Corp., between December 6, 1978 and January 4, 1979, the period during which respondent engaged in a number of substantial trades while in the possession of material non-public information.

2 The action was dismissed on the pleadings for failure to state a claim upon which relief may be granted. Fed. R. Civ. P. 12(b)(6). Accordingly, the allegations of the complaint must be accepted as true. *Cruz v. Beto*, 405 U.S. 319, 322 (1972); *Conley v. Gibson*, 355 U.S. 41, 45-6 (1957).

settlement of a contract dispute with the United States Navy resulted in a large influx of cash, the Board of Directors of General Dynamics met in November 1978 and considered restoration of the cash dividend. It was agreed that as a result of the settlement the company was in a position to resume dividend payments, but final action was deferred until January 4, 1979, the next scheduled Board meeting. Nevertheless, the SEC—which later conducted an investigation and decided to proceed against General Dynamics—concluded:

> By December, 1978 the probability that [General Dynamics] would declare a dividend was sufficiently high and the magnitude of such an event was sufficiently great, that [General Dynamics] was required to have disclosed the facts surrounding the potential resumption of its dividend payments or refrained from trading in its own stock while in possession of those facts.[3]

General Dynamics did not, however, refrain from trading. Between December 6 and December 29, 1978, it purchased a total of 157,000 shares of its own stock at an average price of $79.37 per share. The stated purpose for these purchases was to fund the company's "Management Incentive Program" through which senior employees receive stock and stock options as part of their compensation. By making these purchases without disclosing the upcoming dividend, General Dynamics was able to achieve a cost savings in excess of $1.5 million, based on the post-announcement price of $89.75 per share.

On January 4, 1979, General Dynamics requested a halt in trading of its stock on the New York Stock Exchange and

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3 SEC Memorandum dated October 12, 1979 from The Division of Enforcement to The Commission. The Commission proceeded against General Dynamics for insider trading violations and entered into a consent decree which, while requiring General Dynamics to install safeguards against future violations, did not require disgorgement of profits or any other compensation to defrauded security-holders. *SEC v. General Dynamics Corp.*, Civil Action No. 80-0279-C(2) (E.D. Mo. 1980).

announced, for the first time, that a cash dividend of $3 per share would be paid and that this dividend, for reasons surrounding the settlement with the Navy, would not be considered taxable income to the recipient shareholders. Also announced was a 2½ for 1 stock split. When trading resumed, the price of General Dynamics common stock leaped from $81.125 to $89.75; convertible preferred increased from $52 to $55; and the "February 90" call options rose from $187.50 to $537.50.

The "February 90" call options, ten of which were purchased by petitioner on the CBOE in October 1978, gave him the right, until February 17, 1979, to purchase a total of 1,000 shares of General Dynamics common stock at $90 per share. On January 4, 1979, just hours before the trading halt on the New York Stock Exchange and the dividend announcement, petitioner sold his options for $187.50 each. Had petitioner known, however, of the information which General Dynamics had wrongfully withheld from the marketplace, he would have received a substantially higher price for his securities, in line with the $537.50 post-announcement value.

Petitioner filed this action in order to recover damages for himself and all others who sold General Dynamics' securities while the market price was artificially depressed by respondent's failure to reveal material information which, under § 10(b) and Rule 10b-5, it was obligated to disclose.

Proceedings Below

The District Court, upon respondent's motion, dismissed the complaint pursuant to Fed. R. Civ. P. 12(b)(6) on the ground that "a relationship of trust and confidence . . . could not have existed between [petitioner] and [respondent] who had no direct dealings" and accordingly, under *Chiarella v. United States*, 445 U.S. 222 (1980), respondent "had no duty to disclose [to petitioner] the dividend that was going to be declared." The District Court did find, however, that such a relationship of trust and confidence existed between General

Dynamics and holders of its common and preferred stock and thus was unable to say "with substantial certainty" that these persons could not state a claim. (19a) Initially, the District Court did not dismiss as to stockholders. (15a)[4]

The Court of Appeals, although acknowledging that "the issue [was] not free from doubt," affirmed the District Court's dismissal of the complaint. (4a) The Court of Appeals, citing *Chiarella*, held that no relationship of trust and confidence existed which would create a duty of disclosure running to petitioner. The court also reasoned that "General Dynamics was not privy to any contract with [petitioner]" and declared it "fundamental . . . that the purchase of the options did not represent contribution of capital to the corporation." (6a; *see also*, 3a, n.2) Alternatively, the court found that petitioner lacked standing because he had not traded in the same market as respondent; there was no "transactional connection in their trading." (11a)

REASONS FOR GRANTING THE WRIT

The court below has decided an important issue under the federal securities laws which will have ramifications far beyond the circumstances presented by this particular case. The question presented by this Petition is whether options—which Congress has expressly declared to be securities as a matter of federal law (Exchange Act, § 3(a)(10), 15 U.S.C. § 78c(a)(10)) and which are just as sensitive to fraud or manipulation as common stock—should be singled out and deprived of the protections afforded by § 10(b) and Rule 10b-5.

Petitioner sues for damages sustained as a result of General Dynamics' violation of the "disclose or abstain" rule under § 10(b) and Rule 10b-5. As this Court noted in *Chiarella*:

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4 No stockholder, however, sought relief either separately or together with petitioner. For this reason, the entire action was eventually dismissed.

The obligation to disclose or abstain derives from

> [a]n affirmative duty to disclose material information [, which] has been traditionally imposed on corporate "insiders," particularly officers, directors, or controlling stockholders.

445 U.S. at 227, *quoting*, *Cady, Roberts & Co.*, 40 SEC 907, 911 (1961). The prohibition against insider trading extends to the issuing corporation itself, *Green v. Hamilton International Corp.*, 437 F. Supp. 723, 728-9 (S.D.N.Y. 1977) (and cases cited therein); gives rise to a private right of action, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974);[5] and requires the wrongdoer, at a minimum, to disgorge his ill-gotten profits, *Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

In the present case, there is no question that the conduct of General Dynamics exposed it to civil claims by the SEC (which did in fact bring suit) and by those who sold common stock during the period in question. (Neither court below questioned stockholders' standing to sue.) Respondent was also exposed to criminal liability. The court below held, however, that petitioner, an options-trader, did not have standing to challenge respondent's conduct.

Petitioner submits that this distinction between options and other securities is unwarranted for two reasons:

First, a gaping loophole would be created in the protections intended by Congress under the federal securities laws. The decision below strips option-traders of any right of action against insiders who trade stock, *or even options*, on the strength of material non-public information.[6] As shown below,

5 This Court has recently reconfirmed that § 10(b) and Rule 10b-5 create a private right of action for damages. *Herman & MacLean v. Huddleston*, ___ U.S. ___, 103 S.Ct. 683, 74 L.Ed. 2d 548 (1983).

6 This result follows necessarily from the Court of Appeals' insistence that even an *insider* must have a fiduciary or other "special relationship" with an injured plaintiff. Rarely, if ever, will such a relationship exist in the case of traders in the options market.

there is considerable incentive to trade options on inside information. The SEC lacks the resources to ferret out all (or even most) instances of such wrongdoing. The decision below, in removing the deterrent of private actions by option-traders, widens the door to recurrent fraud and manipulation which will undermine investor confidence in the national options exchanges and will frustrate Congress' stated purpose of insuring "the maintenance of fair and honest markets in such transactions." Exchange Act, § 2; 15 U.S.C. § 78b.

Second, the court below, in requiring privity of dealing and a fiduciary relationship between traders, ignores the practicalities of modern securities markets. The Court of Appeals' anachronistic viewpoint, if upheld, must necessarily limit the reach and effectiveness of the federal securities laws. Rather, attention should focus on the impact of the wrongdoing. Where, as here, it is obviously foreseeable that proscribed conduct will affect one security (options) just as directly as it affects another (stock), no distinction should be drawn based on outmoded notions of privity or restrictive concepts of fiduciary duty. As this Court has observed on a number of occasions: "securities laws combating fraud should be construed 'not technically or restrictively, but flexibly to effectuate [their] remedial purposes.' " *Herman v. MacLean*, *supra*, 74 L.Ed.2d at 558 (and cases cited therein).

A. The Court Below Has Created A Loophole In The Federal Securities Laws Which Will Invite Fraud And Injure Investors In The Public Options Markets

Full scale exchange trading of stock options began in this country just ten years ago. By 1977, the CBOE was second only to the New York Stock Exchange in terms of trading volume. Today, in addition to the CBOE, options are traded on the American, Philadelphia, Pacific and Midwest Stock Exchanges. Altogether, options on more than 220 different underlying stocks are available to investors.

All listed options, including those traded by petitioner, are registered under the Securities Act of 1933, 15 U.S.C. § 77a, *et*

seq. Moreover, it is clear beyond peradventure that Congress intended options to be included within the protections of the Exchange Act. Section 3(a)(10) of the Act, 15 U.S.C. § 78c(a)(10), defines "security" to include "any. . . stock . . . or any. . . right to subscribe to or purchase, any [stock]."

As this Court observed in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 751 (1975):

> [T]he holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as "purchasers" or "sellers" of securities *for purposes of Rule 10b-5*, not because of a judicial conclusion that they were similarly situated to "purchasers" or "sellers," but because the definitional provisions of the 1934 Act themselves grant them such a status. [Emphasis added].[7]

Because of the "leverage" inherent in options, the potential exists for reaping staggering profits literally overnight while putting only modest amounts of capital at risk. The trick is to enter the market at precisely the right time—a feat sometimes accomplished by the astute or the lucky, but all to often it is the result of inside information. Several recent cases amply demonstrate the irresistible lure which the options market holds out to the unscrupulous. In *SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111, 113 (S.D.N.Y. 1981), several Americans (hoping to cover their tracks by operating through a foreign bank subject to Swiss secrecy laws) used inside information about an imminent takeover bid to reap "a virtually overnight profit just short of $2 million." In another well-publicized case, option traders with inside information achieved "overnight profits of over $900,000 on a total investment of about $8,600." 15 Sec. Reg. L.. Rep. (BNA) 991 (May 27, 1983) reporting guilty plea in *United States v. Nugent*, (D.D.C. May 20, 1983). In a third case, Thomas Reed, a special assistant to President Reagan,

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7 Both § 10(b) of the Exchange Act and Rule 10b-5 apply, by their express terms, to "any security".

settled SEC charges that he used inside information to make more than $427,000 in profit on a 48 hour investment of only $3,125 in the options market. W. Williams, "Insider Trading and Options", *New York Times*, April 13, 1983 at p. D1.[8]

The examples cited, and the conduct of General Dynamics in the instant case, are reminiscent of the egregious practices which plagued the securities markets in the years leading up to and following the Crash of 1929. Congress, in an attempt to discover what could be done to curtail these practices and to restore investor confidence, held extensive hearings at which a variety of abuses was presented. Prominent among them was insider trading:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.

L. Loss, *Securities Regulation* (Vol. II) at 1037 (2d ed. 1961), *quoting*, Stock Exchange Practices, Report of Comm. on Banking & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) at 55. One example of insider trading which was

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8 It has also been reported that John S. R. Shad, Chairman of the SEC, was reluctant to proceed civilly against Mr. Reed and failed to recommend criminal prosecution because, as a result of the decision of the District Court *in the case at bar*, there was "uncertainty over whether trading options on the basis of insider information was illegal." K.B. Noble, "Role in Reed Case Defended by S.E.C.", *New York Times*, March 23, 1983 at p. D8. The Court of Appeals' affirmance, of course, does nothing to dispel this "uncertainty."

"frequently described to the committee [was] where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase *or resumption* of dividends . . . ." Senate Report No. 792, 73d Cong., 2d Sess., April 20, 1934 at 9 (emphasis added).[9]

The decision below, in distinguishing between options and other securities, all expressly covered by the Exchange Act, has, for option traders, turned the clock back to pre-1934 days by creating a loophole in the law which will attract the unscrupulous and leave their victims without the protections intended by Congress. *See, e.g.* E. Brodsky, "Insider Trading," *New York Law Journal*, June 15, 1983 at p. 1; D.C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement," 70 Cal. L. Rev. 1, 41 (1982). The Court of Appeals purports to rely upon this Court's decision in *Chiarella* as the basis for its distinction between options and other securities.[10] Such reliance, however, is misplaced.

In *Chiarella*, this Court began with the proposition that Mr. Chiarella was *not* an "insider." 445 U.S. at 231.[11] Accordingly,

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9 Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b), permits the corporation to recoup profits made by officers, directors or large shareholders on short-swing trades. Section 10(b), aptly described as a "'catchall' antifraud provision" (*Herman & MacLean, supra*, 74 L.Ed.2d at 555), applies to trades by the corporation itself and allows recovery of damages to investors.

10 Professor Langevoort also points out that indiscriminate application of *Chiarella's* "fiduciary relationship" test would also immunize insider trading in debt securities, since the relationship between the insider and the victim is one of debtor/creditor, not fiduciary. Langevoort at 40. The rationale of the court below leads to just this result, even though, like options, bonds, debentures, etc. are "securities." Exchange Act § 3(a)(10).

11 *Chiarella* was a printer who had no connection with (or confidential information from) the company in whose stock he traded. Rather, in the course of his work, he had access to information concerning upcoming tender offers. Using this information he bought stock in the target company which, once the tender offer was announced, appreciated rapidly.

the Court was obliged to search for some other source of a "duty to disclose," the *sine qua non* of a Rule 10b-5 violation based on silence. Finding that Chiarella had no fiduciary or other relationship of trust and confidence which would require him to break an otherwise entirely proper silence, the Court found no violation. The court below, however, read *Chiarella* to mean that there must exist a fiduciary or other relationship of trust and confidence even before *an insider* is under an obligation to disclose or abstain.

This extension of the *Chiarella* reasoning to insiders, which were plainly not the subject of the *Chiarella* holding, creates the loophole with respect to options (and probably debt securities as well; *see* n.10, *supra*).[12] It is a loophole which is certain to have unfortunate consequences for public investors and which should be closed by this Court so the SEC may proceed confidently to deter insider trading in the options markets (*cf.* n.8, *supra*) and so that private enforcement will be available in the circumstances presented here to provide what this Court has called "a necessary supplement to Commission action." *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).[13]

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12 This extension of *Chiarella* to insiders is also inappropriate given Congress' stated objective of ensuring fair and honest securities markets. This objective is more likely achieved by imposing stricter duties of disclosure upon insiders than upon printers. After all, it is insiders who are most likely to have information which should be disclosed and it is insiders who were singled out by Congress for special attention when the Act was passed. *See* pp. 10-11, *supra*.

13 At least two courts have held that option-holders are entitled to the same protections against insider trading as are holders of other types of securities. *Backman v. Polaroid Corp.*, 540 F. Supp. 667, 671 (D. Mass. 1982) (granting option-holders standing to attack inside trades in underlying common stock) and *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F.Supp. 1179 (S.D.N.Y. 1981) (where insiders themselves traded in options). The Court of Appeals was aware of these cases but declined to follow them. (10a-11a).

B. The Court of Appeals' Reliance Upon Notions of "Privity" And "Special Relationships" Is Misplaced, Given The Nature Of Modern Securities Markets

As noted (p. 6, *supra*), the Court of Appeals exonerated respondent because it "was not privy to any contract with [petitioner]" and there was no fiduciary or other relationship of trust and confidence which would create a duty to disclose. Reliance upon these concepts, however, overlooks the actualities of dealing in today's impersonal securities markets and, consequently, will hobble the remedial purposes of § 10(b) and Rule 10b-5.

In *Blue Chip Stamps, supra*, 421 U.S. at 745, this Court pointed out:

> In today's universe of transactions governed by the [Exchange] Act privity of dealing or even personal contact between potential defendant and potential plaintiff is the exception and not the rule.

Recognizing this reality, the courts have widely held that privity of dealing is not a prerequisite to a Rule 10b-5 action:

> [Rule 10b-5] does not require that defendant be the seller of the stock or that plaintiff have purchased the stock from defendant. The district judge apparently resurrected the notion that in a Rule 10b-5 action, there must be "privity" between a plaintiff and a defendant. This view is now discredited.

Baretge v. Barnett, 553 F.2d 290, 291 (2d Cir. 1977). *Accord, Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), *reh. denied*, 404 U.S. 1064 (1972); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Texas Continental Life Insurance Co. v. Dunne*, 307 F.2d 242, 249 (6th Cir. 1962). The same is true when the Rule 10b-5 action involves insider trading. *Shapiro, supra*, 495 F.2d at 239. The prime reason for the abandonment

of any privity requirement is well-stated in *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974):

> Implementation of rule 10b-5 is dependent on private enforcement, and a requirement of privity in every instance would narrow the focus of section 10(b) and its implementing rule from the broad protection of investors to the punishment of direct buyers or sellers whose acts violated the statute and rule.[14]

The concept of privity has been replaced in current decisional law by a requirement of a causal connection or nexus between the defendant's wrong and the plaintiff's injury. *Sargent, supra*, 492 F.2d at 760-61. In the context of insider trading, this connection is supplied by the "causation in fact" test: "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." *Shapiro, supra*, 495 F.2d at 239.

In the instant case, petitioner obviously would have been influenced to act differently if defendant had disclosed the upcoming dividend. More important, the entire market of General Dynamics' common stock, preferred stock and stock options would have traded at prices which reflected this dividend and all investors would have been operating on an equal basis. Instead, prices remained artificially depressed and

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14 In the present case, if the Court of Appeals' privity requirement is strictly applied, General Dynamics would not even be liable to those who sold common stock during the period on exchanges such as the Midwest or Pacific where General Dynamics' stock is listed but the Company did not trade. Indeed, liability would be limited to those few whose sell orders could be later matched to General Dynamics' buy orders—a result criticized in *Shapiro, supra*, 495 F.2d at 236:

> [T]hese transactions occurred on an anonymous national securities exchange where as a practical matter it would be impossible to identify a particular defendant's sale with a particular plaintiff's purchase. And it would make a mockery of the "disclose or abstain" rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty to disclose had been violated.

General Dynamics, the only market participant with complete information, was able to exploit these low prices and reap for itself a handsome profit. Where, as here, causation is present, privity of dealing need not be shown.

The Court of Appeals' need for a fiduciary or other "special relationship" between defendant and plaintiff is similarly inappropriate given the realities of today's impersonal securities markets. While such a fiduciary duty or special relationship may be necessary before a *non-insider*, such as the printer Chiarella, may be compelled to speak, the rule is (and should be) quite different when an *insider* is involved. As noted above (pp. 10-11 and n.12), insiders were responsible for some of the "most vicious practices" uncovered by Congress. Insiders obviously have access to the most crucial information and can thus have a far more significant impact upon national securities markets (and investor confidence in those markets) than would a printer like Chiarella.

It is therefore appropriate to apply a stricter duty of disclosure upon insiders than upon printers or other "outsiders". In this regard, an insider's duty of disclosure runs "to the investing public." *Shapiro, supra*, 495 F.2d at 240; *SEC v. Texas Gulf Sulphur, supra*, 401 F.2d at 848. Where, as here, that duty of disclosure has been breached, liability should extend to all those directly and foreseeably injured by that breach—a class which, in this case, must necessarily include sellers of call options, such as petitioner. The market price of options is directly tied to the price of the underlying common stock. Any violation which depresses the price of the stock will directly and foreseeably depress the price of call options as well. Thus an option-holder is just as directly affected by violation of a duty to disclose as is a shareholder, and should be entitled to the same right to bring an action for his losses.

CONCLUSION

For the reasons stated herein, a writ of certiorari should issue to review the decision of the United States Court of Appeals for the Eighth Circuit.

Dated: New York, New York
July 5, 1983

Respectfully submitted,

ROBERT B. BLOCK
Attorney for Petitioner
295 Madison Avenue
New York, New York 10017
(212) 532-4800

Of Counsel:

BRUCE G. STUMPF
Pomerantz Levy Haudek Block
& Grossman
295 Madison Avenue
New York, New York 10017
(212) 532-4800

JOHN L. DAVIDSON, JR.
Greenfield & Davidson
721 Olive Street
St. Louis, Missouri 63101
(314) 241-5735

APPENDIX

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS
EIGHTH CIRCUIT

Submitted March 9, 1982 Decided April 6, 1983

No. 81-1986

DONALD I. LAVENTHALL,
Appellant,

—v.—

GENERAL DYNAMICS CORPORATION,
Appellee.

Shepherd, Sandberg & Phoenix, John G. Shepherd, Jonathan Ries, Richard L. Prebil, St. Louis, Mo., for appellee; Jenner & Block, Clarold L. Britton, Laura A. Kaster, Chicago, Ill., of counsel.

Greenfield, Davidson, Voorhees & Hamlett, John L. Davidson, Jr., Thomas H. Pollihan, St. Louis, Mo., for appellant; Pomerantz, Levy, Haudek & Block; Robert B. Block, Bruce G. Stumpf, New York City, of counsel.

Before:

LAY, *Chief Judge*, and
ROSS and MCMILLIAN, *Circuit Judges*.

LAY, *Chief Judge.*

This is an appeal from the summary dismissal of plaintiff's complaint in an action alleging violations of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), and rule 10b-5 of the Securities and Exchange Commission (SEC), 17 C.F.R. § 240.10b-5 (1982). Donald Laventhall was the purchaser of call options that gave him the right to purchase 1000 shares of common stock in General Dynamics Corporation from October 13, 1978, to February 17, 1979. Without disclosing a pending declaration of a cash dividend, General Dynamics purchased 157,500 shares of its own common stock on the open market in December 1978. On the afternoon of January 4, 1979, General Dynamics declared a cash dividend and a stock split.

Laventhall filed a class action on behalf of all persons who sold call options or other securities of General Dynamics between December 6, 1978, and January 4, 1979. He claimed that General Dynamics improperly traded stock on undisclosed material inside information.

The district court, the Honorable Clyde S. Cahill presiding, ruled that General Dynamics had no duty to disclose any information to Laventhall because the coporation did not have a fiduciary or similar relationship of trust to an options holder, and the court dismissed the complaint as to call options holders. *Laventhall v. General Dynamics Corp.*, No. 80-0305-C(5) (E.D.Mo. April 6, 1981). Laventhall thereafter requested the court to direct notice to surviving class members, including stockholders, under rules 23(d)(2) and 23(e) of the Federal Rules of Civil Procedure. The district court refused to do so on the grounds that rule 23(e) applies only to voluntary dismissals and that notice was not justified under rule 23(d)(2) because surviving class members would not be prejudiced by dismissal of the action. The court additionally found that Laventhall was no longer an adequate class representative under rule 23(a)(3). *Laventhall v. General Dynamics Corp.*, 91 F.R.D. 208 (E.D.Mo.1981). Upon dismissal of the complaint, this appeal followed. We affirm the judgment of dismissal.

Facts.

Prior to the January 4, 1979, announcement General Dynamics had not declared a cash dividend on common stock since 1971.[1] Beginning in 1978 General Dynamics began to take steps in preparation for declaring a cash dividend in 1979. Between December 6 and December 29, 1978, without disclosing that a payment of a dividend was being considered, the corporation purchased 157,500 shares of its common stock on the open market. The shares were allegedly purchased for the its management incentive program.[2] It was not until January 4, 1979, that General Dynamics disclosed its intention to declare a dividend. On that date the General Dynamics board unanimously approved the dividend plan whereby a $3 dividend would be paid for each pre-split common share and at the same time there would be a 2½ for 1 stock split. Thereafter, the common stock went from 81⅛ to 89¾ on January 5, 1979, the day after the announcement.

The plaintiff, Donald Laventhall, purchased ten call options on the Chicago Board of Options Exchange issued by the

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1 According to pleadings filed in an action brought by the SEC, *SEC v. General Dynamics Corp.*, Civ. No. 80-0279-C(2) (E.D.Mo. Feb. 27, 1980), the alleged reason no earlier dividends had been declared was that General Dynamics had to make large cash outlays to construct nuclear submarines pursuant to a disputed contract with the Navy. This dispute was settled in September-October 1978; thereafter it is alleged steps were taken by General Dynamics to declare a dividend on its common stock.

2 On February 27, 1980, the SEC and General Dynamics entered into a consent decree, Civ. No. 80-0279-C(2) (E.D.Mo. Feb. 27, 1980), in which General Dynamics denied any wrongdoing concerning the purchase of the securities and issuance of the dividend; nonetheless General Dynamics, based upon allegations of the SEC complaint, agreed to maintain in the future certain policies and procedures regarding disclosure of material information with respect to purchases of securities. It is significant to point out that what is at stake in the present lawsuit, although not made clear by plaintiff's complaint, is that underlying the alleged undisclosed declaration of dividend is the SEC allegation that General Dynamics' tax department undertook an analysis that the projected dividend *could* be construed as a nontaxable-return of capital instead of a taxable dividend.

Options Clearing Corporation on October 13, 1978, at a total price of $5500. These options gave Laventhall the right to purchase 1000 shares of General Dynamics Corporation common stock at $90 per share until February 17, 1979. Laventhall never exercised his options and sold them on the morning of January 4, 1979 for $1875.

Discussion.

The fundamental issue relates to Laventhall's standing as an options holder to bring suit against a corporation trading solely in common stock. The district court found he had no standing. Although we find the issue not free from doubt, we affirm the judgment of dismissal of the district court.

Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).
Rule 10b-5, promulgated under section 10(b), provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

* * *

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1982).

An option is a security as defined in section 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1976). The term "security" is defined to include a "warrant or right to subscribe to or purchase [stock]." *Id.; see Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 750-51, 95 S.Ct. 1917, 1932-33, 44 L.Ed.2d 539 (1975); 2 L. Loss, *Securities Regulation* 1075 (2d ed. 1961).

Section 10(b) and rule 10b-5 have been applied to prohibit corporate insiders from trading without disclosing material, inside information.[3] In *In re Cady, Roberts & Co.,* 40 S.E.C. 907, 912 (1961), the Commission ruled that corporate insiders must either disclose material inside information known to them or refrain from trading in the shares of the corporation. *See SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969).

Laventhall argues that the corporation's failure to disclose its dividend plans before purchasing its common stock was a violation of this duty to abstain or disclose. He urges that General Dynamics had an obligation to disclose the information to all investors or, alternatively, that he was injured by the corporation's violation of its duty to disclose the information to its shareholders.

The options at issue were issued by Options Clearing Corporation. The record contains several documents explaining op-

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3 The Supreme Court, as has this court, recognized an implied private remedy for violation of section 10(b) and rule 10b-5. *See Herman & MacLean v. Huddleston,* ____ U.S. ____, 103 S.Ct. 683, 686-87, 74 L.Ed.2d 548 (1983).

tions trading. An option to purchase (a call option) represents a contract with a private brokerage firm to purchase stock in the future at a specified price. Options are bought because they offer an investor a potential profit from a limited dollar exposure; on the other hand, trading in options can be far more speculative than the purchase of common stock or other securities. Even though the stock price may increase, options may expire worthless. If the option is not exercised, that is, the contract not performed, or if the option itself is not sold before expiration, the buyer may lose its entire purchase price. It is common knowledge that the risk in options trading is enhanced because of the definite and short-lived nature of the contract. A significant factor in options trading is that the purchaser pays only a premium on the original purchase of the option.

In the present case, General Dynamics was not privy to any contract with the plaintiff; at no time did it consent to issuance, sale, or purchase of the options. It is fundamental for our understanding that the purchase of the options did not represent contribution of capital to the corporation. Judge Lasker in *O'Connor & Associates v. Dean Witter Reynolds, Inc.,* 529 F.Supp. 1179 (S.D.N.Y. 1981), further expands the contrast between the share and option holder. He wrote:

> The relationship between corporate insiders and shareholders stands in stark contrast to the lack of relationship between the corporate insiders and options traders. While it is true that shareholders and options traders both rely on the fortunes of corporations, the dispositive distinction is that the options trader has no equity interest in the corporation by virtue of his selling or purchasing an option on the corporation's stock. He is owed no special duty by the officers and directors of the corporation because, quite simply, the corporation is not run for his benefit. He has contributed no equity to the corporation and, in the event of insider wrongdoing, he has no right to bring suit to make the corporation whole. Moreover, while the option writer may obligate himself in the future

> to purchase shares of the corporation (in the event a "naked option" is exercised), this purchase is solely for the purpose of turning the shares over to the other contractual party, not for the purpose of investing in the fortunes of the corporation. Whatever relationship this may create with the corporation, it cannot be said that it rises to the level of a relationship of trust and confidence between the options trader and the corporate insider. In short, as a shareholder one is entitled to the benefits of a trust relationship. As an options trader, one is not.

Id. at 1184-85.

The absence of a relationship of trust and confidence, as described above, led the district court to dismiss plaintiff's complaint under rule 12(b)(6) of the Federal Rules of Civil Procedure.

In *Chiarella v. United States,* 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980), the defendant, a printer's employee, used confidential information delivered to his employer for printing by potential acquiring companies in connection with planned corporate takeovers. The defendant used the information to purchase stock in the target companies before the takeover attempts were announced, without disclosing his inside information to the persons from whom he purchased the stock. After the takeover bids were publicly announced, the printer sold the stock and made large profits. An indictment was returned charging him with violation of section 10(b) and rule 10b-5. He was found guilty.

The Supreme Court reversed the conviction on the ground the defendant did not have a duty to disclose his information to either the target company or the sellers of its stock. As the Supreme Court held:

> [O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

Id. at 228, 100 S.Ct. at 1114 (quoting Restatement (Second) of Torts § 551(2)(a) (1977)).

Plaintiff argues that *Chiarella* can be distinguished because General Dynamics is an "insider" and Chiarella was not. This may be true, but plaintiff fails to demonstrate that General Dynamics as an insider owed any special duty to the plaintiff who merely held an option to buy General Dynamics' stock from a third party. There simply existed no relationship of trust and confidence between the parties. As *Chiarella* makes clear, "liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction.*" 445 U.S. at 230, 100 S.Ct. at 1115 (emphasis added). It is true that when a general investor buys stock of a corporation on the public market there exists no contract between the corporation and the buyer. However, as suggested by Chief Judge Learned Hand in *Gratz v. Claughton,* 187 F.2d 46, 49 (2d Cir.), *cert. denied,* 341 U.S. 920, 71 S.Ct. 741, 95 L.Ed. 1353 (1951), "the director or officer assumed a fiduciary relation to the buyer by the very sale." Upon the purchase of the call option by plaintiff, the same cannot be said concerning the relation between the officers of General Dynamics and the plaintiff. They were still complete strangers and ordinarily no duty would be owed.

Laventhall asserts, however, that General Dynamics, as an insider, possessed a general duty "to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets." *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228, 235 (2d Cir. 1974); *see also United States v. Newman,* 664 F.2d 12, 15-17 (2d Cir. 1981).

It is important, however, to emphasize that no cause of action arises under section 10(b) or rule 10b-5 simply because an insider has inside information and fails to disclose it. The duty arises only where there is a breach of the rule that an insider must "disclose or abstain" from trading. *Fridrich v. Bradford,* 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053, 97 S.Ct. 767, 50 L.Ed.2d 769 (1977). The *sine qua*

non in every private action under section 10(b) is unauthorized trading of securities in the same market as the persons damaged. *See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 169 (2d Cir. 1980). In the present case, for example, plaintiff must concede that his claim for damages could not be asserted had General Dynamics not purchased securities in the market. Assuming it had not done so, even though it possessed inside information, plaintiff would have sold his options at the same loss he now claims without any potential claim for relief. We think this illustration necessarily points up the need to show some transactional nexus between defendant's trading and plaintiff's loss. Had plaintiff been contemporaneously trading in the same market; that is, buying and selling common stock at the same time defendant was trading, there would arguably exist a transactional nexus that defendant had profited through the purchase of stock, whereas plaintiff contemporaneously had sustained a loss through the sale of his stock due to the imbalance of information. The legal justification for liability of the corporate insider to the outside uninformed investor is that if the insider trades on the basis of the inside information it may profit at the expense of outside investors who are disadvantaged in the same or similar transaction by lack of the inside information. Thus, in this hypothetical transaction there is a direct nexus between the defendant's gain and the plaintiff's loss.

However, the same analysis cannot be applied to a transaction between an options holder dealing with a third party and the corporate insider or his tippee dealing with shares of stock. There is only a speculative relationship between the insider's trading and the alleged loss caused to the options holder. It may be true that the nondisclosure may have had some indirect effect on the option premium, but the insider's trading of stock on the stock market has no transactional nexus with the option holder's loss on the options exchange. *Cf. Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir. 1981) (duty owed only to those investors trading contemporaneously in time with the insider). Here defendant's purchase of stock, if done wrongfully as claimed,

could not in any way be asserted as the basis for plaintiff's alleged loss because the parties were not dealing in the same market. The defendant's alleged illegal gain is remote and totally speculative in relation to the plaintiff's loss in a different market, even though the plaintiff is a member of the investing public. We find there must be some special relationship between plaintiff and defendant before a duty of disclosure arises. Here there is none. Plaintiff is not trading with the insider or the insider's company. He has bought no interest in it. He is a member of the investing public but he is not investing in the defendant's company. As we said in *St. Louis Union Trust Co. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925, 98 S.Ct. 1490, 55 L.Ed.2d 519 (1978):

> In order to prevail in an action for securities fraud under § 10(b) and Rule 10b-5, a plaintiff must show some causal nexus between the defendant's wrongful conduct and his (the plaintiff's) loss. This requirement preserves the basic concept that causation must be proved else defendants could be held liable to all the world.

Id. at 1048 (footnote omitted).[4]

Plaintiff relies on *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F.Supp. 1179 (S.D.N.Y. 1981), wherein the court found options traders had standing to sue insiders of a corporation and their tippees who were dealing with undisclosed inside information. Judge Lasker reasoned: "Consequently, by virtue of their *fiduciary* duty to the corporation and its shareholders, corporate insiders become subject to the

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4 Plaintiff may contend, on the basis of *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972), that causation is presumptively established by defendant's trading without disclosure. We disagree. *Affiliated Ute* involved parties that had dealt directly with each other and there clearly was a duty of disclosure owed. The plaintiffs there had a right to expect the defendants would fully disclose all material information. There is no such relationship in the instant case. "The type of relationship existing between plaintiffs and defendants in *Affiliated Ute* is totally absent here." *Fridrich v. Bradford*, 542 F.2d at 320.

separate duty to either 'abstain or disclose.'" *Id.* at 1187 (emphasis original).[5] Notwithstanding this reasoning, we find no standing in the present case since plaintiff and defendant lacked any transactional connection in their trading. In *O'Connor* Judge Lasker emphasized that defendant was alleged to be fraudulently trading in call options. Significantly the court observed:

> Moreover, it was the defendants' own choice to trade in options rather than stock, and if, as O'Connor alleges, the defendants' options trading was fraudulent, there is no good reason to permit them to avoid compensating those directly injured by their conduct. Furthermore,

5 We recognize that two district courts, one from the Eastern District of Missouri, *In re McDonnell Douglas Corp. Securities Litigation*, [1981-1982 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 98,737 (E.D.Mo.1982) (Hungate, J.) and *Backman v. Polaroid Corp.*, 540 F.Supp. 667, 671 (D.Mass.1982) (McNaught, J.), have recognized the right of option holders to sue as a class against corporate insiders selling stock without making material disclosures. We disagree with these holdings. However, we note one commentator agrees with this view:

> Plainly, a narrow reading of *Chiarella*, foreclosing application of the abstain-or-disclose rule to options trading, would open a large loophole for insiders to profit from confidential information. The options trading marketplace as a whole, however, is a mechanism whereby large numbers of persons *do* effectively commit to buy and sell shares, albeit with prices arrived at well before the ultimate transaction and subject to contingencies. Since options marketplace activity does result in at least some persons becoming shareholders of the issuer and others giving up their issuer shares, there is little basis for distinguishing the derivative (options) market from the primary (share) market for disclosure purposes. Then, the issue of what type of security is subject to the insider-trading prohibition is closely related to the question of to whom the duty of disclosure is owed. If the insider's duty is to the entire marketplace, not circumscribed by a privity requirement, it should follow that options trading on the basis of material nonpublic information is prohibited. It can generally be demonstrated that the marketplace involves sales by some persons who are issuer shareholders (or purchases by persons who become shareholders), so that the fiduciary duty is present at least with respect to those persons.

Langevoort, *Insider Trading and the Fiduciary Principle: A Post* Chiarella *Restatement*, 70 Calif.Rev. 1, 42 (1982) (footnote omitted).

> O'Connor's argument that denying options traders standing in the context of insider trading cases would create a broad loophole in the rules against insider trading is persuasive. The private cause of action for securities fraud was implied in order to provide a mode of compensation for those persons directly injured and to augment the enforcement mechanisms of the securities laws. Excepting options traders from the implied cause of action would work against those purposes.

529 F.Supp. at 1188.

We think our holding is in accord with the Supreme Court's observation that civil remedies in section 10(b) cases should not be extended to those who possess only a tangential relationship to the transaction. *Blue Chip Stamps*, 421 U.S. at 747-49, 95 S.Ct. at 1931-32; *see also Fridrich v. Bradford*, 542 F.2d at 323 (Celebrezze, J., concurring). We find further support for our view that the options holder must at least deal in the same market as the insider in the Second Circuit's opinion in *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981). The court there was concerned with the breadth of the class of shareholders bringing suit against corporate insiders. In finding that there had to be allegations of a contemporaneous transaction to provide an individual with standing the court observed:

> To extend the period of liability well beyond the time of the insider's trading simply because disclosure was never made could make the insider liable to all the world. *See Shapiro*, 495 F.2d at 239; *Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970). Any duty of disclosure is owed only to those investors trading contemporaneously with the insider; non-contemporaneous traders do not require the protection of the "disclose or abstain" rule because they do not suffer the disadvantage of trading with someone who has superior access to information. *See Fridrich v. Bradford*, 542 F.2d 307, 326 (6th Cir. 1976) (Celebrezze, J., concurring), *cert.*

denied, 429 U.S. 1053, 97 S.Ct. 767, 50 L.Ed.2d 769 (1977). This court recently reiterated such a limitation on the scope of liability under rule 10b-5 for insiders trading in the open market:

> The knowing use by corporate insiders of non-public information for their own benefit or that of "tippees" by trading in corporate securities amounts to a violation of Rule 10b-5 . . . which may give rise to a suit for damages by uniformed outsiders *who trade during a period of tippee trading*.

Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (emphasis added) (citations omitted).

648 F.2d 94-95.

Similarly, Judge Celebrezze observed in his concurring opinion in *Fridrich v. Bradford*:

> Neither an insider's trading when he is not in possession of material inside information, nor the decision to abstain from trading when he does possess such information, gives rise to a duty of disclosure. That duty arises only when necessary to equalize the information available to outside investors who are actively trading with an insider who is privy to undisclosed material facts. When the insider ceases trading, the informational imbalance ends and the market returns to its normal state.

542 F.2d at 327.

Here, although it would appear there are sufficient allegations of contemporaneous trading, it is clear there is only a speculative nexus between Laventhall, as an options holder, and the corporate insiders dealing with stock. Regardless of General Dynamics' nondisclosure and purchase of stock there was no informational imbalance in the separate transactions performed by the corporation and Laventhall because they in no way can be said to have been "trading" with one another. To urge, as plaintiff does, that the value of the stock directly or indirectly influenced the value of his options does not, without

some more tangible connection, create an insider's duty beyond the class of investors section 10(b) and rule 10b-5 were designed to protect. *Cf. Fridrich v. Bradford*, 542 F.2d at 318-22 (defendants' trading with third parties not causally connected with plaintiffs' claimed loss).

In view of our holding, we find no abuse of discretion in the district court's denial of plaintiff's standing to represent a class of similarly situated stockholders.

Judgment affirmed.

Order of the District Court

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF MISSOURI
Eastern Division

No. 80-0305-C (5)

DONALD I. LAVENTHALL,

Plaintiff,

—v.—

GENERAL DYNAMICS CORPORATION,

Defendant.

ORDER

As per the memorandum which will be forthcoming,

IT IS HEREBY ORDERED that defendant's motion to dismiss is GRANTED as to the call option holders and DENIED as to the holders of securities.

IT IS FURTHER ORDERED that plaintiff's motion for class certification is STAYED until further evidence is presented to the Court suggesting that a class action would still be appropriate.

The memorandum will follow and copies will be forwarded to the parties.

Dated this 31st day of March, 1981.

/s/ CLYDE S. CAHILL

Clyde S. Cahill
United States District Judge

Decision of the District Court

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF MISSOURI
Eastern Division

No. 80-0305-C (5)

DONALD I. LAVENTHALL,

Plaintiff,

—v.—

GENERAL DYNAMICS CORPORATION,

Defendant.

MEMORANDUM

As per the order entered March 31, 1981, this matter is before the Court on defendant's motion to dismiss, or in the alternative for more definite statement, and plaintiff's motion for class certification.

Plaintiff brings this purported class action under Fed. R. Civ. P. 23(b)(3) on behalf of all persons who sold call options or other securities of defendant from December 6, 1978, through January 4, 1979, and were damaged as a result.

According to the complaint, defendant corporation had not declared a cash dividend on its common stock since 1971. Between December 6, 1978, and January 4, 1979, defendant's management considered issuing a cash dividend to its common stockholders. Before announcing this news, between December 6 and December 29, 1978, defendant purchased 157,500 shares of its own common stock on the open market at the average price of $79.37 per share. These shares were to be used by

defendant for its Management Incentive Stock Program. On January 4, 1979, defendant declared an annual dividend of $3.00 per share on its common stock, and a stock split on its common stock on the basis of 2½ for 1. Prior to the dividend announcement, The New York Stock Exchange, at the request of defendant, halted trading in defendant's common stock. Before the halt, defendant's common stock traded at $81.125 per share. Upon resumption of trading, the price reached $89.75 per share. Plaintiff contends that defendant was obligated to disclose the dividend information to the investing public or to abstain from trading in its securities while such information was undisclosed under section 10(b) and rule 10(b)(5) of the Securities Exchange Act of 1934. As a result of the nondisclosure, plaintiff, the owner of ten call options entitling him to purchase defendant's common stock until February 17, 1979, claims that members of the purported class (i.e., call option holders, common stock holders, etc.) were damaged by selling their securities for prices lower than they could have had the dividend information been revealed. Therefore, plaintiff prays on behalf of the class for damages, costs, and attorney's fees.

Defendant moves to dismiss or for a more definite statement under Fed. R. Civ. P. 12(b)(6) and Fed. R. Civ. P. 12(e). Defendant claims that the complaint fails to state a claim upon which relief can be granted for one or more of the following reasons:

a) General Dynamics owed no duty of disclosure to plaintiff.

b) There is no causal connection between General Dynamics' alleged violation of the Securities Act and plaintiff's alleged injury.

c) Plaintiff has failed to plead facts sufficient to show he sustained any loss.

d) Plaintiff has failed to allege scienter and fraud with sufficient particularity to satisfy the requirements of Rule 9(b) of the Federal Rules of Civil Procedure.

The Court finds that only the first reason has merit. To reiterate, defendant's first argument is that defendant owed no duty of disclosure to plaintiff under section 10(b) and rule 10(b)(5) of the Securities Exchange Act of 1934. The Supreme Court in *Chiarella v. United States*, 445 U.S. 222, 235, held that a duty to disclose under section 10(b) does not arise from the mere possession of nonpublic market information. Furthermore, one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. The duty to disclose arises when one party has information that the other party is entitled to know because of a *fiduciary or other similar relation of trust and confidence* between them. *Id.* at 228.

The question, then, is whether plaintiff and defendant were in a fiduciary relationship or a relationship of trust and confidence. Although this action has not been certified as a class action, plaintiff purports to represent the class of persons who sold *call options* or *other securities* between December 6, 1978, and January 4, 1979. It is gleaned from plaintiff's motion for class certification that the term *other securities* includes common stock and convertible preferred stock. A relationship of confidence and trust has been recognized between shareholders of a corporation and corporate insiders, particularly officers, directors, and controlling shareholders. *Chiarella*, 445 U.S. at 228; *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

In the instant action, plaintiff was a call option holder who purchased from the Chicago Board of Options Exchange and not the defendant. Conceivably, a relationship of trust and confidence existed between plaintiff and the Chicago Board of Options Exchange, but such a relationship could not have existed between plaintiff and defendant who had no direct dealings. Since a relationship of confidence and trust was not in existence, defendant had no duty to disclose the dividend that was going to be declared. Therefore, plaintiff fails to state a claim upon which relief can be granted under Fed. R. Civ. P. 12(b)(6) in his individual capacity and as to other call option holders that he purports to represent.

Since a relationship of trust and confidence does exist between shareholders of a corporation and corporate insiders, the Court finds that such a relationship may have existed between the *other security* holders (i.e., common stockholders, convertible preferred stockholders, etc.), non-call option holders, and the defendant who purchased its own stock via an agent, officer, director, or other corporate insider. For this reason, the Court cannot say with substantial certainty that plaintiff fails to state a claim as to the purported *other security holders* (i.e., non-call option holders). Therefore, defendant's motion to dismiss is granted as to the call option holders and denied as to the *other holders of securities* that plaintiff purports to represent.

Additionally, plaintiff filed a motion for class certification under Fed. R. Civ. P. 23(c)(1). As the defendant's motion to dismiss has been granted in part and denied in part, the Court will stay the motion for class certification pending further presentation of evidence suggesting that a class action would still be appropriate.

Dated this 6th day of April, 1981.

/s/ CLYDE S. CAHILL

Clyde S. Cahill
United States District Judge